

STATE OF NEW YORK
DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
	:	
of	:	
	:	
POHATCONG INVESTORS, INC.	:	DETERMINATION
	:	
for Redetermination of a Deficiency or for	:	
Refund of Corporation Franchise Tax under	:	
Article 9-A of the Tax Law for the Fiscal	:	
Year Ending February 28, 1981.	:	

Petitioner, Pohatcong Investors, Inc., 4 Harriet Lane, Plainview, New York 11803, filed a petition for redetermination of a deficiency or for refund of corporation franchise tax under Article 9-A of the Tax Law for the fiscal year ending February 28, 1981 (File No. 53801).

A hearing was held before Doris E. Steinhardt, Hearing Officer, at the offices of the State Tax Commission, Two World Trade Center, New York, New York, on October 10, 1985 at 1:15 P.M., with all briefs to be submitted by January 9, 1986. Petitioner appeared by McCarthy, Fingar, Donovan, Drazen & Smith (Martin Drazen, Esq., of counsel). The Audit Division appeared by John P. Dugan, Esq. (Anne W. Murphy, Esq., of counsel).

ISSUE

Whether the gain realized by petitioner from trading in covered call options may properly be characterized as income from investment capital within the meaning and intent of section 208.5 of the Tax Law.

FINDINGS OF FACT

Petitioner by its representative, Martin Drazen, Esq., and the Audit Division by its representative, John P. Dugan, Esq. (Anne W. Murphy, Esq., of counsel), entered into a stipulation of facts which is incorporated into this decision.

1. Petitioner, Pohatcong Investors, Inc. ("Pohatcong"), is a New York corporation which operates as an investment company.

2. Pohatcong timely filed its New York corporation franchise tax reports for the fiscal year March 1, 1980 through February 28, 1981, reporting and paying a tax of \$2,917.25.

3. Pohatcong computed its franchise tax on the basis of an allocation of its business and investment income as follows:

Investment income for allocation		\$625,348.52
Allocation percentage	4.665%	
Allocated investment income		\$ 29,172.51
Business income	-0-	

4. On April 19, 1984, the Audit Division issued to Pohatcong a Statement of Audit Adjustment and a Notice of Deficiency for the period ending February 28, 1981 in the base tax amount of \$22,733.67 plus interest. The asserted basis for the notice was the Audit Division's determination that Pohatcong's reported net gain from trading in stock options, amounting to \$246,034.89, should have been allocated at the business allocation percentage of 100 percent. The Audit Division takes the position that stock options are not investment capital within the meaning and intent of section 208, subdivision 5 of the Tax Law.

5. At a pre-hearing conference, the Audit Division conceded that the correct net gain from stock options was \$233,090.35 and, on this basis, reduced the deficiency asserted to a base tax of \$21,499.60.

6. A stock option is a contract between two parties by which one party obtains the right to either buy or sell shares of identified stock from the other party at a fixed or determinable price within a specified time. Call options give the holder the right to "call," or buy, the stock, while put options give the holder the right to "put," or sell, the stock. All options, both calls and puts, have a buyer and a "writer" or seller. Options are normally bought or sold in 100 share units.

7. All of Pohatcong's gains and losses from trading in stock options in the tax year at issue were incurred as the result of the sale of calls written on stock held in its portfolio. Such options are termed "covered call" options.

8. The price of a covered call option is normally determined by the length of the option period and the relationship between the exercise price and the market price of the underlying stock on the date the call is written. Generally speaking, the buyer of a call option anticipates a

rise in the price of the underlying stock, while the writer of the option does not expect the price of the underlying stock to rise above the exercise price. A major objective in writing covered call options is to earn a greater return via premium income than would be earned on the stock investment alone. The writer may also want to minimize its losses (by earning a return via premium income) if the price of the underlying stock declines.

9. For franchise tax purposes, Pohatcong treated the covered call options which it wrote as securities and interpreted the income it received from the sale of these options as investment income, including it in the base against which the investment allocation percentage was applied.

10. Stock options are widely traded through stockbrokers across the country. Their prices are listed daily in The New York Times and The Wall Street Journal, and the options are publicly traded in the open market or on a recognized exchange.

11. Stock options are recognized as securities by the United States Securities Act of 1933 and the Securities Exchange Act of 1934.

12. All the stock options dealt with by Pohatcong were listed options purchased and sold through Pohatcong's stockbrokers, Merrill, Lynch, Pierce, Fenner and Smith and McMillion/Eubanks, Inc. [cleared through Donaldson, Lufkin, & Jenrette Securities Corporation].

CONCLUSIONS OF LAW

A. That subdivision 5 of section 208 of the Tax Law defines "investment capital," insofar as pertinent, as:

"[i]nvestments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer...."

The statute does not define the term "other securities"; however, the regulations limit other securities to:

"securities issued by corporations of a like nature as stocks and bonds, which are customarily sold in the open market or on a recognized exchange, designed as a means of investment, and issued for the purpose of financing corporate enterprises and providing a distribution of rights in, or obligations of, such enterprises." (20 NYCRR 3-4.2[c]; see also, Matter of Avon Products, Inc. v. State Tax Commn., 90 AD2d 393).

B. That in defining a security, as the term is used in the above statute, it is proper to look at the function of the instrument, to search for substance over form with emphasis on economic reality (United Housing Foundation v. Forman, 421 US 837; see also, Matter of Avon Products, Inc., supra). It should be noted in this regard that:

"In general, it may be said that any form of instrument used for the purpose of financing and promoting enterprises, and which is designed for investment, is a security according to the modern meaning of that term" (Matter of Waldstein, 160 Misc 763, 767).

The "call" options issued by petitioner have none of the essential attributes of a security: they are not issued for the purpose of financing corporate enterprises; they do not provide a distribution of rights in and obligations of such enterprises; and they are not designed as a means of investment (cf. Cohn, Ivers & Co. v. Gross, 56 Misc 2d 491 [holding that a call is not a security for the purpose of UCC §8-102 because, inter alia, "it does not finance an enterprise, nor is it designed for investment."].)

C. That the fact that calls and puts are sold on recognized exchanges and included in the definitions of a security found in Federal and State regulatory statutes is not controlling. The major objectives of those statutes are to protect the public from the fraudulent schemes of promoters and to maintain public confidence in the integrity of the market (see Matter of Gardner v. Lefkowitz, 97 Misc 2d 806). To further these objectives, a broad rule of construction governing the terms and provisions of these statutes has been adopted (People v. Haynes, 2 Misc 2d 983). Since World War II, and especially in the past fifteen years, there has been a proliferation of "[f]inancial instruments designed to speculate on, or hedge against, fluctuations in interest rates and exchange rates, as well as stock market movements and other economic changes..." (1982 US Code Cong & Admin News 2780, 2781). Thus, when the Securities Exchange Act of 1933 et al were amended in 1982 to include calls and puts in the definition of a security, the purpose of the legislation was to clarify the jurisdiction of the Securities and Exchange Commission and to confirm that agency's "historic mandate to foster the integrity of the market" (1982 US Code Cong & Admin News 2780). Article 9-A is narrower in its scope and operation than the securities and exchange laws. The regulation confines the term

"other securities" as used in the tax statute to those instruments "of a like nature as stocks and bonds" (20 NYCRR 3-4.2[c]). Clearly, calls and puts are not "like" stocks and bonds. Consequently, calls and puts do not qualify as items of investment capital within the meaning of the Tax Law.

D. That the petition of Pohatcong Investors, Inc. is denied, and the Notice of Deficiency issued on April 19, 1984, as modified (Finding of Fact "5"), is sustained.

DATED: Albany, New York
November 16, 1987

ADMINISTRATIVE LAW JUDGE